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Report of Working Group V (Insolvency Law) and Working Group VI (Security Interests) on the work of their first joint session (Vienna, 16-17 December 2002)

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I. Introduction

1. At its thirty-fifth session (2002), the Commission noted with particular satisfaction the efforts undertaken by Working Group VI (Security Interests) and Working Group V (Insolvency Law) towards coordinating their work on a subject of common interest such as the treatment of security interests in the case of insolvency proceedings. Strong support was expressed for such coordination, which was generally thought to be of crucial importance for providing States with comprehensive and consistent guidance with respect to the treatment of security interests in insolvency proceedings. The Commission endorsed a suggestion made to revise chapter X of the draft legislative guide on secured transactions in light of the core principles agreed by Working Groups V and VI (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). The Commission also endorsed a suggestion for closer coordination of the work of the two working groups, including a suggestion to hold a one-day joint meeting of the two working groups at their upcoming sessions.[1]

II. Organization of the session

2. Working Group V (Insolvency Law) and Working Group VI (Security Interests), which were composed of all States members of the Commission, held their first joint session in Vienna, from 16 to 17 December 2002. The session was attended by representatives of the following States members of the Working Groups: Argentina, Austria, Cameroon, Canada, China, Colombia, France, Germany, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lithuania, Morocco, Romania, Russian Federation, Rwanda, Singapore, Spain, Sweden, Thailand, The former Yugoslav Republic of Macedonia and United States of America.

3. The session was attended by observers from the following States: Algeria, Australia, Belarus, Bulgaria, Denmark, Indonesia, Lebanon, New Zealand, Philippines, Poland, Republic of Korea, Slovakia, Switzerland, Syrian Arab Republic, Turkey, Ukraine and Venezuela.

4. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: International Monetary Fund (IMF) and the World Bank; (b) intergovernmental organizations: Asian-African Legal Consultative Organisation (AALCO), Common Market for Eastern and Southern Africa (COMESA), European Bank for Reconstruction and Development (EBRD) and International Institute for the Unification of Private Law (UNIDROIT); (c) non-governmental organizations invited by the Commission: American Bar Association (ABA), American Bar Foundation (ABF), Center for International Legal Studies, Center of Legal Competence (CLC), Commercial Finance Association (CFA), Europafactoring, International Bar Association, Committee J (IBA), International Federation of Insolvency Professionals (INSOL), Max-Planck-Institute, Society of European Contract Law (SECOLA), The Association of the Bar of the City of New York and Union of Industrial and Employers' Confederations of Europe (UNICE).

5. The Working Group elected the following officers:

Chairman: Mr. Alexander MARKUS (Switzerland, in his personal capacity);

Rapporteur: Mr. Thammanoon PHITAYAPORN (Thailand)

6. The Working Groups had before them the following documents: A/CN.9/WG.V/WP.62 and A/CN.9/WG.VI/WP.5 (provisional agenda), A/CN.9/WG.VI/WP.6/Add.5 (Draft legislative guide on secured transactions, Chapter IX. Insolvency) and A/CN.9/WG.V/WP.64 (Draft legislative guide on insolvency law: Treatment of secured creditors in insolvency).

7. The Working Groups adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Consideration of the treatment of security rights in insolvency proceedings.
4. Other business.
5. Adoption of the report.

III. Deliberations and decisions

8. The Working Groups considered the treatment of security rights in insolvency proceedings on the basis of chapter IX, Insolvency, of the draft legislative guide on secured transactions (A/CN.9/WG.VI/WP.6/Add.5). The deliberations and decisions of the Working Groups are set forth below in part IV. The Working Groups noted with particular satisfaction that, as a result of their fruitful cooperation, their deliberations and decisions were based on principles and policies that were consistent, an approach that was indispensable for providing comprehensive and consistent advice to States with respect to the treatment of security rights in insolvency proceedings. The Secretariat was requested to prepare, on the basis of those deliberations and decisions, a revised version of chapter IX, Insolvency, of the draft legislative guide on secured transactions.

IV. Consideration of the treatment of security rights in insolvency proceedings

A. Introduction (paras. 1-5)

9. With respect to paragraph 2, it was agreed that it should clarify that, while the protection of the economic value of encumbered assets was important to secured transactions regimes, insolvency regimes attached importance to the protection of the value of all assets of the insolvency estate. It was also agreed that the reference to monitoring the activities of debtors should be toned down on the basis that the draft guide should not impose obligations that could not be met and could negatively affect the availability and the cost of credit, or go into a detailed discussion of obligations under the security agreement.

10. With respect to paragraph 4, it was suggested that the distinction between liquidation and reorganization needed some further elaboration to take into consideration other techniques, such as the sale of a business as a going concern, and that that change should be reflected throughout chapter IX.

B. Key objectives (paras. 6-8)

11. It was agreed that the principle that the effectiveness of a security right should be recognized in an insolvency proceeding subject to avoidance actions should be emphasized. It was noted that that principle was also reflected in the draft insolvency guide (see A/CN.9/WG.V/WP.63/Add.9, para. 170 and recommendation 71). It was also agreed that the reference to priority should be understood as relating to competing claims rather than to a distinction between effectiveness as against the debtor and effectiveness and priority as against third parties. In addition, it was also agreed that reference should be made to the impact of post-commencement financing on the rights of existing secured creditors.

C. The inclusion of encumbered assets in the insolvency estate (paras. 9-15)

12. It was noted that Working Group V, in defining the property to be included in the estate (for the purposes of both liquidation and reorganization), had agreed that in addition to assets of the debtor, the estate should include rights of the debtor, whether of a proprietary, contractual or other nature (see A/CN.9/529, para. 82 and recommendations 27 and 30.). In agreeing that that formulation should be reflected in the draft guide on secured transactions, the Working Groups noted that rights of the buyer/debtor with respect to retention of title arrangements would be included in the estate, irrespective of whether they were characterized as property or contractual rights or whether the rights of the seller/creditor were treated as security rights or not (an issue that remained to be resolved in the draft guide on secured transactions).

D. Limitations on the enforcement of security rights (paras. 16-22)

13 It was noted that Working Group V had completed a detailed discussion of the application of the stay and the variety of measures required to protect secured creditors (see A/CN.9/529, paras. 114-124 and recommendations 40-42). After discussion, the Working Groups agreed that the chapter on insolvency in the draft guide on secured transactions should be consistent with the draft insolvency guide on those issues. It was suggested that paragraph 20 should be expanded to indicate the standard against which the safeguards should be assessed (for example, the position the secured creditor would have been in had it enforced its security prior to commencement of proceedings).

14. With respect to the question in paragraph 22 whether the value of the encumbered assets after payment of the secured claim ("surplus") should be part of the estate, it was agreed that reference should be made to the treatment of retention of title arrangements in the various legal systems. It was stated that, in some legal

systems, in the case of a sale under a retention of title arrangement, the seller could retain any surplus. In response, it was observed that in other legal systems any surplus, even in retention of title arrangements, would be part of the estate. It was stated that the matter might depend on whether retention of title arrangements were treated as security rights and on whether the relevant contract was continued or terminated by the insolvency representative. As to the discussion of the use and disposition of assets in paragraph 22, it was agreed that it should reflect the thrust of the approach taken with respect to that matter in recommendations 44, 45 and 51 of the draft insolvency guide (see A/CN.9/529, paras. 131 and 139-140).

E. Participation of secured creditors in insolvency proceedings (paras. 23-24)

15. With respect to paragraph 23, it was agreed that it should be revised to reflect the principle that, as encumbered assets were part of the estate, secured creditors were affected and should be allowed to participate effectively in the insolvency proceedings, including in any negotiations aimed at an amicable settlement.

16. As to paragraph 24, it was agreed that it should reflect more accurately recommendation 110 of the draft insolvency guide as to the extent to which secured creditors would be represented in creditor committees (see A/CN.9/WG.V/WP.63/Add.11).

F. The validity of security rights and avoidance actions (para. 25)

17. It was noted that paragraph 26 reflected a principle contained in the draft insolvency guide (see A/CN.9/WP.63/Add.9, para. 170 and recommendation 171). After discussion, it was agreed that reference should be made to the effectiveness as against the debtor and its creditors, since the notion of "validity" referred to the relationship between the secured creditor and the debtor and implied a contractual right. It was also agreed that with respect to the question whether avoidance actions could be initiated not only by the insolvency representative but also by creditors, reference should be made to the relevant discussion in the draft insolvency guide (see A/CN.9/529, paras. 164-165). In addition, it was agreed that the reference to payment of post-commencement proceeds of encumbered assets should be clarified by adding that that matter related to liquidation proceedings and strengthened to the effect that payment "should be made" and not just "be possible". The suggestion was made that reference should be made to avoidance of a secured transaction for the lack of registration. In response, it was stated that that might not be necessary since the source of ineffectiveness in such a case was secured transactions law rather than insolvency law.

G. Relative priority of security rights (paras. 26-28)

18. With respect to paragraphs 26 and 27, it was agreed that the principle that pre-commencement priority should be respected subject to limited and clearly prescribed exceptions, should be reflected more clearly. As to the note in italics, various views were expressed. One view was that the note should be deleted as it

could be taken as a recommendation to legislators to adopt unnecessary exceptions to the principle in paragraphs 26 and 27 (privileged claims, carve-outs, equitable subordination). Another view was that the note should be retained subject to the clarification that the exceptions referred to in the note were made in some countries only. Yet another view was that the exceptions were examples and should be retained as they were. After discussion, it was agreed that the text in the note should be retained but revised to clarify that any exceptions made were examples of approaches taken in some countries and that their adoption could have a negative impact on the availability and the cost of credit.

19. As to paragraph 28, it was agreed that the principle that costs for the administration of the estate should not be given priority over the claims of secured creditors should be reflected more clearly. It was also agreed that the exception to that principle (costs of maintaining the encumbered assets) should be further clarified.

H. Post-commencement financing (paras. 29-35)

20. With respect to paragraph 29, it was agreed that it should make it clearer that post-commencement financing should be considered as an option only where appropriate.

I. Reorganization proceedings (paras. 36-41)

21. With respect to the discussion of the protection of the economic value of a security right in paragraph 39, it was agreed that the value should be no less than the value of the security right in the case of liquidation proceedings.

J. Expedited reorganization proceedings (paras. 42-45)

22. The substance of paragraphs 42 to 45 was found to be generally acceptable.

K. Summary and recommendations (paras. 46-53)

23. It was agreed that paragraphs 46 to 53 should be revised to reflect the above-mentioned decisions of the Working Groups. In particular with respect to retention of title arrangements, it was confirmed that whether they were to be treated as security rights or not (which was a matter of secured transactions law addressed in other chapters of the draft guide on secured transactions), either the assets or the value of the price paid by the buyer would be part of the estate (see para. 12).

Notes

[1] *Official Records of the General Assembly, Fifty-Fourth Session, Supplement No. 17* (A/54/17), para. 203.